No. 6449.

IN THE

# United States

# Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

H. Stanley Bent,

*Petitioner,*

*vs.*

Commissioner of Internal Revenue,

*Respondent.*

## PETITIONER'S BRIEF.

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## PETITIONER'S BRIEF.

This is a petition to review an order of the United States Board of Tax Appeals redetermining the income tax liability of the petitioner for the calendar year 1920. This is a companion case to that of Arthur S. Bent, Docket No. 6450, in this court, which was heard and determined upon the same evidence before the Board of Tax Appeals, and, pursuant to stipulation filed herein, the said cause of Arthur S. Bent is to abide the judgment and decision herein if such judgment be rendered upon the merits.

## STATEMENT OF THE CASE.

Petitioner was a member of the copartnership of Bent Brothers for several years prior to and including the years 1920, 1921, and 1922, which said partnership was engaged in the business of constructing reservoirs, dams and similar works. During the year 1920 the partnership executed work on certain unit-price contracts of the same general nature of terms and price as shown by Petitioner's Exhibit No. 1 [Tr., p. 145], except that the Huntington Park Reservoir was a cost-plus contract. The contract for San Dimas Dam, which is typical, is set out at length in the transcript at pages 53-116.

The contracts affecting income taxes here in question are the following [Tr., p. 162-165 and 169-169]:

| Name of Contract. | Amount of Work Executed Each Year. | | | |
|---|---|---|---|---|
| | 1919 | 1920 | 1921 | 1922 |
| Devil's Gate Dam | $140,362.97 | $81,838.85 | | |
| Huntington Park Reservoir | | 18,107.27 | 4,097.89 | |
| Rodeo Drain | | 19,955.60 | 9,259.90 | |
| San Dimas Dam | | 9,464.10 | 273,390.45 | $80,982.60 |

Under these contracts settlements were to be made monthly for the number of units moved, based on a determination by the owner's engineer, the owner agreeing to pay therefor, less a stipulated hold-back, on a certain date in the following month. [Tr., pp. 157-160.] The owner's engineer determined the quantity of work done each month, applied the unit price provided by the contract and furnished a copy of his determination to the contractor, Bent Brothers.

Bent Brothers kept their books on an accrual basis, that is, the bookkeeper entered in the books the cost of all contracts incurred during the month the work was performed for labor, supplies and expense, and at the end of each month [Tr., pp. 177-179] also entered in the books the amount earned during that month on each of the contracts by charging the owner for 100% of the work and crediting income accounts. At the end of each year Bent Brothers distributed general office expenses, including salary to partners and general employees, to the several jobs worked on during that year on the basis of the cost of each job during the year to the total cost of all work done during the year, thus accruing on the books all of the income and all of the expense for each contract, including cost-plus (force account) contracts, to the end of each calendar year, thus placing expenses and income on an annual accrual basis [Tr., pp. 187 and 191].

In preparing income tax returns on the calendar year basis for the partnership all of the income, costs and expenses accrued upon the books were ignored, except from contracts fully completed. The net income of the partnership computed by this erroneous method was not the net income as reflected by the partnership books [Tr., pp. 188 and 192], and as a consequence the petitioner, in turn, did not report and pay tax upon his share of the correct partnership net gain as shown by the partnership books of Bent Brothers. Petitioner made a return for the year 1920 and included therein his share of all of the partnership net income from the Devil's Gate Dam job, although $140,362.97 was earned on this contract in 1919 and $81,838.85 in 1920 and the net profit reported on the job by the partnership was $26,099.39.

Bent Brothers and this petitioner filed amended returns for the calendar years 1919, 1920, 1921, and 1922, in December, 1923, in order to bring their returns in conformity with the method of accounting regularly employed by the partnership, and also filed claims for abatement and refund of taxes paid and unpaid as shown by original returns. The respondent delegated an internal revenue agent to examine the claims, amended returns and the books of Bent Brothers. The revenue agent rendered a report rejecting the amended returns, allowing abatement of tax caused by an error and changing certain overhead items shown on the original returns, and the respondent approved the findings of the revenue agent and notified taxpayer of his determination [Tr., pp. 17 to 21]. Petitioner appealed to the Board of Tax Appeals, which sustained the action of the commissioner.

## ASSIGNMENT OF ERRORS.

Petitioner relies upon the following assignments of error:

(1) The board erred in holding that the original returns of the partnership of Bent Brothers and of this petitioner for the calendar year 1920 were made in accordance with the method of accounting regularly employed in keeping the books of the partnership.

(2) The board erred in holding that the original returns made by the partnership of Bent Brothers and of this petitioner for the calendar year 1920 clearly reflected the annual net income of said partnership and of the petitioner during the said year.

(3) The board erred in holding that the income derived by the petitioner from unit and cost-plus

contracts extending in the course of performance over a period of more than one calendar year or from one calendar year into another calendar year were properly reported in the return filed for the calendar year in which the work was completed or finished, notwithstanding the fact that a portion of said income was earned and accrued upon the books of the partnership in a preceding calendar year or preceding calendar years, and the amount of net income derived from said contracts during each of said calendar years was clearly reflected in the partnership books of account.

(4) That the board erred in finding as a fact that the method pursued by the partnership of Bent Brothers and the petitioner in returning net income was in accordance with the method of accounting regularly employed in keeping the partnership books.

(5) That the board erred in failing to find that the original tax returns filed by petitioner for the years 1920 and 1922 did not correctly reflect his net income for said year.

(6) That the board erred in finding that the amended income tax return filed by petitioner for the years 1920 and 1922 did not correctly reflect his net income for said years.

* * * * * * * * *

(8) That the board erred in holding that it did not have jurisdiction to hear or determine the petitioner's appeal with respect to his income tax liability for the calendar year 1922. [Tr., pp. 137-138.]

## QUESTION INVOLVED AND PETITIONER'S CONTENTIONS.

The first six assignments of error involve substantially the same question, which is the principal one presented upon this appeal and may conveniently be considered together. The question thereby presented is the correct method of accounting and reporting for income tax purposes the income derived from the unit and cost-plus contracts, to which reference has been made in the foregoing statement of the case, which were in the course of performance during a period of time extending beyond a single calendar year, and in this regard petitioner contends:

(1) That income from such contracts should be accounted for and reported during each calendar year (the taxpayer's accounting period) and should not be deferred until the completion of the entire contract, and reported as income for the calendar year in which the contract was completed;

(2) That the books of the partnership, properly considered, were kept upon the accrual basis, and that such books correctly reflected the income derived from each of such contracts in each of the calendar years during which the work thereunder was in progress;

(3) That if it be conceded, for the purposes of argument, that the books were not kept upon this basis, then they did not clearly or correctly reflect annual income, and under the express provisions of the statute the partnership's income tax return could not properly be made upon that basis.

We shall now separately notice each of these contentions in the order stated, after which we will discuss the question presented by the eighth assignment of error.

## THE APPLICABLE STATUTE AND REGULATIONS.

The particular provision of the Revenue Acts of 1918 and 1921 applicable to the question presented is the same in both acts and is to be found in subdivision (b) of section 212, which reads as follows:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

The following provisions of Regulations 45 and 62 are also pertinent:—

Article 36, Regulations 45, reads as follows:

> "Long-Term Contracts.—Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from such gross income should include and be limited to the expenditures made on account of such completed contracts. Or the percentage of profit from the contract may be estimated on the basis of percentage

of expenditures, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year. Upon the completion of a contract if it is found that as a result of such estimate or apportionment the income of any year or years has been overstated or understated, the taxpayer must file amended returns for such year or years. See section 212 of the statute and articles 22-24."

Articles 22, 23 and 24, Regulations 45, insofar as here material, are as follows:—

"Art. 22. Computation of net income.—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 52. If the taxpayer does not regularly employ a method

of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

"Art. 23. Bases of computation.—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * *"

"Art. 24. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *"

Article 36, Regulations 62, reads as follows:

"Art. 36. Long-term contracts.—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon the following bases:

"(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers show-

ing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

"(b) Gross income may be reported in the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice to so treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

"Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. If a taxpayer desires to change his method of accounting in accordance with paragraphs (a) and (b) above, a statement showing the composition of all items appearing upon his balance sheet and used in connection with the method of accounting formerly employed by him, should accompany his return."

## ARGUMENT.

### 1. The Statute Contemplates and Requires an Annual Accounting for Income, and All Income Derived From the Contracts in Question Should Be Accounted for During the Calendar Year in Which It Was Earned.

It is so well settled as to be elementary that "the structure of all revenue statutes is founded upon the principle that there shall be an annual accounting for income" (*Deer Island Logging Co. v. Commissioner,* 14 B. T. A. 1027; *Atkins Lumber Co.,* 1 B. T. A. 317), and a departure from this postulate is authorized or permitted only under the exceptional circumstance that, *when in order to reflect true income*, a different basis is necessary." (*Deer Island Logging Co. v. Commissioner, supra.*)

In other words, regardless of the method of accounting or bookkeeping employed by the taxpayer, the primary requirement is an annual accounting of income, and a return of all income accrued or received during each calendar year. The solution of the question presented, therefore, turns upon the primary inquiry as to whether or not the income from the unit and cost-plus contracts in question, the duration of which extended over a period of more than one calendar year, can be ascertained and accounted for annually or whether such an annual accounting would not "clearly reflect the income." We respectfully submit that such income can clearly and accurately be determined and reported annually, and, therefore, that no other method of returning was permissible under the circumstances. As already stated, the various units of work performed under the contracts in question by the partnership of Bent

Brothers during each calendar year was definitely determined and ascertained; likewise, the price therefor was fixed by the terms of the contracts, and there is, of course, no dispute that the cost of the work performed during each calendar year was also definitely ascertainable. It would, therefore, seem clear that the partnership at the end of each calendar year could accurately ascertain and report the income derived from these contracts to the extent to which they had been performed within the calendar year, and that there is no necessity or justification for deferring this determination and a report of such income until the completion of the contract in a subsequent calendar year. For illustration, to take a typical instance, the Devil's Gate Dam contract was in course of performance by the partnership during the years 1919 and 1920. At the unit prices fixed by the contract the partnership accrued income therefrom during the year 1919 in the total sum of $140,362.97, and in the year 1920 the total sum of $81,838.85. [See Petitioner's Exhibit No. 2, Tr., pp. 162-163, for quantities.] Inasmuch as the cost of performing the various units in each of these years was definitely known and established, and concerning this there is no dispute, it is difficult to understand how it can be said that an annual return of income on this contract could not be made. Yet the partnership in its original return for the calendar year 1919 reported no part of the income thus accrued upon this contract, and manifestly such original return did not correctly reflect the income of the partnership for that period. Like observations are equally applicable to each of the other contracts in controversy. Clearly, under the statute, it was the duty of both the taxpayer and of the respondent to insist upon an annual

accounting for income, and no action on the part of either could operate to defeat its purpose.

Furthermore, viewed either as a question of accounting practice or legal principle, we believe it apparent that the income from unit and cost-plus contracts of the character here involved should be determined and accounted for annually, and not deferred until the completion of a particular contract simply because it extends over a period of more than a single calendar year. Thus in the case of *Owen-Ames-Kimball Company v. Commissioner,* 5 B. T. A. 921, involving construction contracts similar in character to those here under discussion, the Board of Tax Appeal said (p. 928):

> *"The petitioner asks that the income from 13 long-term contracts described in the findings of fact, for each of the years under consideration, be redetermined upon the accrual basis, that is, by treating the income as accruing during the progress of the work under the contracts and allocating the income to the years in which it was actually earned.* If the income from long-term contracts is computed in such a manner, all items of income and expense will be consistently accounted for upon the accrual basis, which will clearly and correctly reflect petitioner's net income. But the Commissioner takes exception to this method of accounting for income derived from long-term contracts, on the ground that under most of these contracts the commissions or fees, representing the petitioner's profits, were not due and payable until completion and acceptance of the work and could not be considered as income prior to the time they became due and payable. *We think the manner of accounting for income from long-term contracts on the basis contended for by the petitioner is proper*

> *under the accrual method of accounting.*" (Italics supplied.)

And further it is said (p. 928):

> "The petitioner's net income for the years 1917 and 1918 should be computed in accordance with the accrual method of accounting, the income from long-term contracts being determined upon the basis that it accrued in the year in which it was earned according to the progress of the work, as evidenced by the expenditures under these contracts."

It is true that by the provisions of article 36, Regulations 45, before quoted, dealing with so-called long-term contracts, a departure from the usual annual basis is permitted, and a taxpayer is permitted to account for income from such contracts during the calendar year in which the contract is completed. In the case at bar the Board of Tax Appeals apparently was of the view that the contracts in controversy came within the classification of "long-term contracts" as that term is used in the Regulations, and that the partnership of Bent Brothers was, therefore, authorized in accounting for income derived from such contracts in the calendar year during which the contract was completed, and that the original returns having been made upon this basis the partnership was barred from filing amended returns upon an annual basis in order to reflect true income and to conform to the method of accounting regularly employed. In this we respectfully submit that the board fell into error.

While the contracts here in controversy may be described as "long-term" by reason of the fact that the

work thereunder extended over a period of more than one calendar year, they are not, in our view, "long-term contracts" as that term is used in the Regulations. As there employed the correct signification of the term comprehends contracts not only the duration of which extends over a period of more than one calendar year, but where the consideration for the work is fixed at a lump sum or flat price, that is to say, a contract where one undertakes to perform a particular work, such as the construction of a bridge or building, which requires more than a single calendar year and where the contracting party agrees to perform the work for a certain total sum. With reference to such contracts it is recognized that it would frequently be extremely difficult, if not impossible, to determine in advance of the actual completion of the work the profit realized or loss sustained in the performance thereof, in any calendar year prior to completion, and hence the usual annual accounting would not correctly reflect income. The mere fact, however, that a particular contract may require more than one year for its performance does not, of itself, present any difficulty in determining annual loss or gain. To illustrate, a corporation enters into a contract to manufacture all of the cans required by a canning company for a period of five years following its execution at a certain stipulated price for each size of can required to be manufactured. While extending over a considerable period of time, this would not constitute a long-term contract, as obviously the manufacturing corporation would have no difficulty in readily ascertaining and accounting for all income accrued from the contract in any calendar year, during its duration. This is the same principle laid down in *Deer Island Log-*

*ging Co. v. Commissioner (supra)* where the unit involved was "a thousand square feet of timber."

With particular reference to the contracts here in controversy, it is to be observed that none of them contemplate the performance of the completed work for a stipulated total price, but that in each instance the partnership agreed to excavate certain rock or earth as might be required at a stipulated price per unit (cubic yard); to place concrete at a certain stipulated price per unit (cubic yard) and to furnish certain materials such as cement at a certain price per unit (sack) without limitation as to the total cost. The contracts, therefore, had none of the features of a long-term contract except the fortuitous circumstance that the performance of the work thereunder might and did extend over a period of more than one calendar year. The contracts, therefore, are not such as are embodied within the term "long-term contracts" as used in the Regulations, and hence the provisions thereof are not applicable here.

Furthermore, if we assume for the purposes of argument that the contracts here in controversy were long-term contracts, the partnership of Bent Brothers was not permitted to account for and report income thereunder upon any other than an annual basis, by reason of the fact that the provisions of the Regulations in question are applicable only to such situations where true income cannot be reflected by resort to the usual annual basis. Speaking of this, the Board of Tax Appeals in *Deer Island Logging Co. v. Commissioner,* 14 B. T. A. 1027, says (p. 1036):

> "We do not believe this is a case which falls within the permissive language of section 212 of the statute, or within the intendment of the regulations of the respondent promulgated in connection therewith. *The application of the long-term contract basis, as permitted by Article 36 of Regulations 45 and 62, is applicable only to such situations where true income can not be reflected by resort to the usual annual basis.*" (Italics supplied.)

We believe that it has already been clearly made to appear that the usual annual basis would correctly reflect the income derived from each of these contracts in each of the calendar years during which they were in course of performance, and hence that such income must be accounted for and reported annually and not deferred until a subsequent period when the contracts were completed.

A case differing in no material respect in principle from that at bar is that of *Deer Island Logging Co. v. Commissioner, supra.* There the petitioner had entered into an agreement with the Lamb Timber Company, which provided, in effect, that the logging company should cut, remove and haul all merchantable timber located upon a tract of real property owned by the timber company, the petitioner furnishing all equipment and labor necessary to accomplish the result, and to pay to the timber company stipulated prices per thousand feet for various classes and grades of timber located upon the property. The timber in question was located upon a tract of approximately 14,000 acres, certain portions of which were readily accessible, and from which the timber might be readily removed, and others from which it was ex-

tremely difficult to effect the removal. In certain areas the timber was sound and of a heavy stand, while in others it was thin and of an inferior quality. Pursuant to the terms of the contract, the petitioner entered upon the performance thereof, its operations covering a period of five years, but made no report of income from the contract until the year 1924, when it was completed, and thereupon claimed deductions for all expenses incurred incident to its operations under the contract, under the claim that its operations were under a "long-term contract" as used in the Regulations, which justified the report of income in the year in which the contract was completed. The commissioner there determined that the income could *not* be reported upon such basis, and determined deficiencies based upon the ascertainment of net income as reflected in the taxpayer's books on a calendar year basis for each of the years during which the work under the contract was in progress. In sustaining the action of the commissioner, and after using the language already quoted above, the board, at page 1038, says:

> "During each of the years in controversy, petitioner realized a substantial income from sales of timber. Those sales, so far as we know, were completed transactions, and the income thus realized could not be altered by any possible future contingency. The income, and all expenses incident to the production thereof, were definitely ascertainable, and the net income of each year could be readily computed, as the respondent has done. No future adverse happening could have any effect upon the net income of these years. Counsel for petitioner also emphasizes that the income for each of the years was not evenly earned and that the stand of timber was

heavy in some areas, while light in others, and that expenditures were uneven, incident to the cutting of the timber. We can perceive no more distinction or hardship in the case of petitioner than any other taxpayer engaged in similar undertakings. An officer of petitioner testified that had petitioner owned the tract of timber in question it would have been subjected to the same business uncertainties and perplexities as they were operating under the contract. If any such happening as petitioner calls to our attention should be met with, it is, under the statutory rules, to be reckoned with and accounted for in the year in which it takes place. Having realized a net income in each of the years in controversy, the petitioner was in duty bound to make an accounting of it for income-tax purposes.

"This petitioner is in no different situation, as concerns its long-term contracts, than a great many other taxpayers who are carrying on business under somewhat similar conditions. In all our major manufacturing industries, it is customary practice to purchase raw materials under contracts extending well into the future. Scores of taxpayers are engaged in the extraction and sale of coal, oil, gas, and other natural deposits, under royalty lease agreements which in a large majority of cases extend over long periods of years. There are others who under like agreements, are taking the timber from our forests for conversion and resale. See Atkins Lumber Co., 1 B. T. A. 317, where we said, 'the taxing statutes have been designed to levy income and profits taxes upon the gains and profits of business for annual periods and each annual period must necessarily, under the provisions of the law, stand by itself.' To hold that none of these realize income until the purchase or royalty agreements have expired, and all of

> the products taken under them have been converted and disposed of, would be a paradoxical ruling without statutory foundation. Yet, that is the logical end to which petitioner's reasoning leads."

The foregoing language is clearly applicable to the case at bar, for, as we have already noticed, the income and all expenses incident to the work performed under each of the contracts in controversy by the partnership of Bent Brothers were definitely ascertainable, and the net income of each year could be readily computed at the close of each calendar year. Thus the accounts kept on the construction of Devil's Gate Dam, to which reference has already been made, showed at the end of the year 1919 that $140,362.97 had been actually earned in that year. The evidence without dispute shows that the cost of earning this sum was accrued in the books of the partnership in the year 1919 [Tr., pp. 173-174; 178]. This being the case, there could be but one course to be followed in determining the actual net income on this contract, and that was to apply the cost against the gross income and determine the gain or loss on this contract on an annual basis or to December 31, 1919. The gross income from this contract during the year 1920 was $81,838.85, which amount is approximately 36.5% of the total earnings upon the contract, and it is manifestly incorrect to ignore the annual accounting period when the figures are available to produce the annual net income, and to account for and report the total amount earned on the contract during the year 1920 simply because the contract was finished in that year.

As indicated by the opinion of the Board of Tax Appeals in the case at bar, upon what is deemed the erroneous assumption that the partnership of Bent Brothers was authorized to account for income under the contracts in question either upon an annual basis or upon completion of the contract, it held that by filing the original returns for the years in question it had elected to account for income upon the completed contract basis and was estopped from reporting upon an annual basis. [Tr., p. 133]. What has already been said we believe completely disposes of this suggestion, for no election can be made between a legal and an illegal method, but an election is permitted only as between two methods either of which is legally applicable. As already stated, a departure from an annual accounting for income is authorized and permitted only where true income cannot be reflected by resort to that basis. (*Deer Island Logging Co. v. Commissioner, supra.*) If, however, the income may be correctly reflected by resort to the annual basis, no right of election is conferred, and regardless of the action of the taxpayer he cannot be said to have estopped himself from correctly reporting his income on an annual basis by reason of his previous erroneous assumption that the same might be reported upon a different basis not authorized by law. Furthermore, each of the revenue acts and the administrative regulations promulgated thereunder not only recognize the right of the taxpayer, upon discovery of an error, to correct his return so as to reflect true income, but are designed to enforce such action upon his part. In discussing a similar principle involving the option conferred by the Revenue Act of 1916, section 13

(d), the Supreme Court in *Aluminum Castings Co. v. Routzahn*, Adv. Op. 1930-31, p. 36, says:

> "By these sections the filing of a return under section 13 (d), where the taxpayer is able to comply with its requirements, is optional if he is also able to prepare a return on the basis of actual receipts and disbursements which reflects true income. *But 'notwithstanding the option given taxpayers, it is the purpose of the Act to require returns that clearly reflect taxable income.'* United States v. Mitchell, 271 U. S. 9, 12, 70 L. ed. 799, 801, 46 S. Ct. 418. By section 13 (b) of the 1916 Act, which was new, the return in every case is required to state such data as are 'appropriate and in the opinion of the commissioner necessary to determine the correctness of the net income returned and to carry out the provisions of this title.' *It follows that the return must be filed on the accrual basis under section 13 (d), where true income cannot be arrived at on the basis of actual receipts and disbursements.* See United States v. Anderson, 269 U. S. 437, 440, 70 L. ed. 349, 350, 46 S. Ct. 131, *supra*." (Italics supplied.)

What has been said, we believe, also serves to clearly distinguish the case at bar from that of *Ellis v. Commissioner,* 16 B. T. A. 1225, cited by the Board of Tax Appeals in its opinion herein. In the cited case, while the facts do not clearly appear from the opinion, there was apparently involved a lump sum contract, by reason of the fact that the board, in support of its conclusion, cites the case of *In re Harrington,* 1 Fed. (2d) 749, which involved contracts of that character, as will appear from the following quotation from the opinion:—

"The firm contracts to do the engineering work for a *stated sum*, depending, of course, upon certain contingencies." (Italics supplied.)

Neither the Ellis nor the Harrington case, therefore, militate against our position, for there was involved in those cases true "long-term contracts" as contemplated by the Regulations. This distinction is also adverted to by the Board of Tax Appeals in *Deer Island Logging Co. v. Commissioner, supra.*

### 2. The Books of the Partnership Were Kept Upon the Accrual Method, and Correctly Reflected the Annual Income Derived From All Sources in Each Calendar Year.

We have already stated in detail the method employed by the partnership of Bent Brothers in keeping its books of account, and concerning the facts stated there is no dispute in the record. Admittedly, the books of the partnership were kept upon an accrual basis and the income and expenses earned or incurred upon each of the contracts in question were accrued monthly with the exception of certain items of general overhead which were apportioned and allocated against the various contracts at the end of each calendar year. [Tr., pp. 173-174; 178]. In view of the evidence in the case at bar, it cannot be successfully contended that the books of the partnership were kept upon any other than the accrual basis, which is defined by the Board of Tax Appeals in the case of *Owen-Ames-Kimball Company*, 5 B. T. A. 921, as follows:

"The accrual method of accounting requires that at the end of every accounting period all income

> which has been earned during the period must be accounted for as income accrued in that period, though perhaps not collected, because it is not due and will not be collected until some future date. It contemplates that the income shall be determined on the basis of a fair distribution between the periods during which the income accrues. Under such a system of accounting a taxpayer accrues income, it does not receive it. Appeal of Clarence Shock, 1 B. T. A. 528 (1925 C. C. H., B. T. A. 2350)."

The Board of Tax Appeals, however, in its opinion, while in nowise controverting the facts as herein stated, concludes that, at least insofar as the contracts here in question are concerned, the books were not kept upon an accrual basis but rather upon a completed contract basis. [Tr., pp. 132-134]. In reaching this conclusion the board relies upon the fact that while the items of income and expense accrued and/or incurred on these contracts were entered as accrued and/or incurred, they were entered "not in general accounts but in specific contract accounts and were not carried into the earnings of the business until the project was completed," [Tr., pp. 132-133] and "not until the completion of the project were these carried into profit and loss to determine gain or loss in the business." [Tr., pp. 132-133.] It is true that the accounts of each of the contracts in question which were uncompleted at the end of a calendar year were not closed in the sense that the loss or gain incurred or earned during the calendar year was carried to profit and loss, but this was, if anything, but an erroneous procedure under a correct method of bookkeeping on the accrual method by which the books were kept, and would not operate to

alter "the method of accounting regularly employed" by the partnership. The method of accounting regularly employed being the accrual method, and it admittedly correctly reflecting the annual income of the partnership, the express provisions of the statute hereinbefore quoted require that the tax return be made in accordance therewith, and this irrespective of whether or not the various items of income and expense were carried in general or specific accounts or whether reflected in an account termed "profit and loss" or in an "investment" or "uncompleted contract account." The rights and duties of the partnership, insofar as income tax is concerned, did not and do not depend upon the terms applied to the various items in the books. The statute is not concerned with mere matters of form, but of the substance (*Doyle v. Mitchell,* 62 L. Ed. 1054, 1060), and looking through the form we find the books of the partnership so kept as to readily and correctly reflect the income derived during each calendar year from all of the operations of the partnership, and it is this income which the law requires to be accounted for regardless of whether or not the partnership or its bookkeeper entered it in a particular account labelled "profit and loss." As is well said by the Circuit Court of Appeals of the Second Circuit, in *Douglas v. Edwards,* 298 Fed. 299:

> "The rights of the parties can neither be established nor impaired by the bookkeeping methods employed nor by the names given to the various items."

And in *Appeal of Max Schott,* 5 B. T. A. 79, 88, it is held that:

> Where the amount of income or deduction is definitely estimable at the end of the taxable year a

taxpayer keeping his books and making his return on the accrual basis will be requested to accrue the amount of such income or deduction for such year even though the computation and entry may not be made until after the close of the taxable year.

*Borden Mfg. Co. v. Comm.*, 6 B. T. A. 276, 278: *Canton Art Metal Co. v. Comm.*, 6 B. T. A. 446; *J. F. Irwin v. Comm.*, 8 B. T. A. 687.

We respectfully contend that the character of a particular method of accounting may not be essentially altered by the method by which profit and loss is determined at the end of an accounting period. When the statute speaks of "the method of accounting regularly employed in keeping the books of such taxpayer" it, of necessity, must have reference to the general system of accounting, and not the detailed accounts or the manner in which isolated items may be treated in the books from time to time. The mere fact that a taxpayer keeping his books upon the accrual basis fails to accrue an item of income during the particular calendar year when earned would certainly not operate to convert his method of accounting to an entirely different method upon which he might return his income for income tax purposes. We, therefore, submit that it cannot be said, as it was by the Board of Tax Appeals, that the original returns filed by the partnership of Bent Brothers for the year in question were in conformity with the method of accounting regularly employed, for they wholly failed to reflect income accrued upon the books of the partnership during that particular period.

### 3. If It Be Conceded, for the Purposes of Argument, That the Books Were Not Kept Upon the Accrual Basis, They Did Not Clearly or Correctly Reflect Annual Income.

From what has already been said, it is manifest that the fundamental requirement of the statute is an annual accounting for income regardless of the method of accounting employed by the taxpayer. Therefore, if we concede, for the purposes of argument, that the Board of Tax Appeals correctly concluded that, by reason of the failure of the partnership of Bent Brothers to carry the items accrued upon its books upon the contracts in question to profit and loss at the end of each calendar year, they were not kept upon the accrual method, it is our contention that, so considered, the books would not correctly reflect income, and the taxpayer could not, if he had so desired, make income tax returns for the year in question upon this basis.

As we have already endeavored to point out in a preceding portion of this brief, an annual accounting may be departed from only when such method does not clearly reflect income, and that in the case at bar an annual accounting is the only method that would truly reflect this income. Therefore, neither by virtue of the method of accounting regularly employed by the partnership, nor otherwise, was it authorized to return income except upon an annual basis. However, if the conclusion of the Board of Tax Appeals upon this phase of the case, that is, that while the partnership accrued income and expenses as earned or incurred, it did not carry the same to profit or loss until the completion of the contracts extending

beyond the calendar year, is correct, it would seem to follow that the books of the partnership cannot be said to have been kept upon any particular method, and it would then be necessary to cast aside the method or methods of accounting employed, and by other means determine what the income of the partnership was for each particular calendar year. Viewed in this light, the situation here presented is identical to that considered by the Board of Tax Appeals in the case of *Owen-Ames-Kimball Company*, 5 B. T. A. 921. As already stated, the taxpayer there was engaged principally in the construction of buildings, the work under which commenced in one taxable year and was completed in another, and the method of bookkeeping there employed may best be described in the language of the opinion as follows:

> "It can not be said that any definite method was employed in keeping the petitioner's books of account. Certain it is that the manner in which the books were kept did not conform either with the cash receipts and disbursements method or the accrual method of accounting, the two alternative methods provided by statute for keeping accounts and making returns of income. Appeal of Chatham & Phenix National Bank, 1 B. T. A. 460 (1925 C. C. H., B. T. A. 2305); Appeal of Henry Reubel, Executor of the Estate of John Kroder, 1 B. T. A. 676 (1925 C. C. H., B. T. A. 2443); Appeal of B. B. Todd, Incorporated, 1 B. T. A. 762 (1925 C. C. H., B. T. A. 2497). All items of income and expense, other than income from long-term contracts, were entered upon petitioner's books and accounted for in accordance with the accrual method of accounting. Income from long-term contracts, an important and perhaps the chief item of income in the petitioner's business, was

accounted for on petitioner's books in an entirely inconsistent manner. There existed no uniform practice as to the time and manner of accounting for income from that source. This income was accounted for at the caprice of the bookkeeper, at irregular periods, and in amounts which were not determined upon any definite or reasonable basis. At times the profit to be derived from long-term contracts was accounted for on the books when work was commenced. On other occasions it was taken up on the books of account during the progress of the work, but at times and in amounts that bore no relation thereto. And as a further variation, there were instances when the income was not accounted for until the completion of the work under contract. In the latter case, the accounting for that income was on the basis of actual receipts, notwithstanding that the expenses incident thereto were accounted for in a prior year and not deferred to be offset against the income."

After detailing the method of accounting employed, the board says:

"It is perhaps superfluous to say that it is a fundamental principle, in computing net income under the several income tax acts, that all items of income and expense shall be consistently accounted for on the same basis; and any method of accounting which fails to recognize and give effect to this principle will not clearly reflect net income. The facts as to the manner in which petitioner's books of account were kept, during the years involved in this appeal, are such that we are convinced that the method employed in keeping the accounts did not conform with either of the two alternative bases provided by statute, and did not clearly reflect petitioner's net income. *It fol-*

*lows that any computation of net income based upon the method employed in keeping the accounts will not result in a correct determination of net income, to which the petitioner is entitled, and resort must be made to some other method."* (Italics supplied.)

Inasmuch, therefore, as the method of accounting employed by the partnership of Bent Brothers, viewed in the light in which it was by the Board of Tax Appeals, did not correctly reflect annual income, the partnership could not legally report the same in conformity therewith, but was required to determine its true annual income regardless of the method of accounting employed and report the same as so determined.

**4. The Board of Tax Appeals Erred in Refusing to Entertain Jurisdiction of the Petitioner's Appeal Covering Income Taxes for the Calendar Year 1922.**

The question now to be discussed arises under the eighth assignment of error [Tr., p. 138], and arises by reason of the refusal of the Board of Tax Appeals to entertain jurisdiction of petitioner's appeal covering income taxes for the calendar year 1922 upon the asserted ground that no deficiency had been determined by the respondent for that year. [Tr., pp. 166-167.] The facts in this connection may be briefly stated.

Petitioner filed an income tax return for the calendar year 1922 showing a net taxable income of $162,459.30. He correctly calculated the tax as follows:

| | |
|---|---|
| 4% on $4,000.00, | $ 160.00 |
| 8% on $155,659.30, | 12,452.74 |
| Surtax, | 52,565.06 |
| Correct total, | $65,177.80 |

These items, with the exception of the total, were as shown by the taxpayer upon his return, but in adding the various items the petitioner set down the wrong total, incorrectly stating it as $66,617.80. On examination of the return the respondent increased the taxable income of the petitioner from $162,459.30 to $163,818.39, or by $1,359.09, and calculated the tax thereon as follows [Tr., p. 32]:

| | |
|---|---|
| 4% on $4,000.00, | $ 160.00 |
| 8% on $156,947.14, | 12,555.77 |
| Surtax, | 53,213.01 |
| Total, | $65,928.78 |

The total last shown is the tax determined by the commissioner.

After the filing of the return the petitioner discovered the error which he had made in addition and on December 14, 1923, filed a claim for abatement. Thereafter, in June, 1925, a revenue agent, acting on instructions from the commissioner to whom the claim was addressed, examined said claim for abatement, noted the error and allowed the claim so far as the overaddition of the items of tax was involved, but delving further into the tax liability of the taxpayer claimed an understatement of taxable income and paired the tax on this claimed understatement or deficiency against the overaddition previously allowed. The action of the revenue agent was approved by the commissioner, and as a result the petitioner's tax liability was accordingly increased over the amount correctly shown by his return, but was less than the total shown by reason of the error in addition already mentioned. Upon these facts the Board of Tax Appeals held

that the action of the commissioner did not constitute the determination of a deficiency and that as a result it was without jurisdiction to hear the appeal.

Sections 273 and 274 of the Revenue Act of 1926, in so far as here material, dealing with the subject of a deficiency, read as follows:

> "Sec. 273. As used in this title in respect of a tax imposed by this title the term "deficiency" means—
>
> (1) The amount by which the tax imposed by this title exceeds the amount shown as the tax by the taxpayer upon his return; but the amount so shown on the return shall first be increased by the amounts previously assessed (or collected without assessment) as a deficiency, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such taxes; * * *"
>
> "Sec. 274. (a) If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within 60 days after such notice is mailed (not counting Sunday as the sixtieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the deficiency. * * *"

We respectfully contend that by virtue of the facts above stated the commissioner determined a "deficiency" by reason of the fact that the amount of tax as determined by him "exceeds the amount shown as the tax by the taxpayer upon his return." A reading of section 273, quoted above, discloses that the statute does not use the word "assessed," and that it is expressly provided that

the amount shown as the tax by the taxpayer on his return shall first be decreased by the amounts previously abated. In the case at bar the abatement of the very apparent error in addition of the tax items as shown by the petitioner's return should have and did take place first by action of the proper representative of the commissioner, and as the tax had not then been paid the abatement was proper, and the action of the commissioner operated to determine a deficiency by reason of the fact that the amount of tax as determined by the commissioner exceeded that as shown by the taxpayer's return. It is true that the commissioner did not forward to the petitioner a notice of deficiency as required by section 274, quoted above, but his failure so to do cannot operate to deprive the Board of Tax Appeals of jurisdiction, as the action taken by the commissioner, in fact, operates to determine a deficiency. The fact which gives the Board of Tax Appeals jurisdiction is the determination of the deficiency, and not the mailing of notice thereof by the commissioner to the taxpayer, which is of importance only in fixing the date when the sixty-day period within which the taxpayer may appeal to the board commences to run.

In the case of *John Moir v. Commissioner,* 3 B. T. A. 21, the Board of Tax Appeals, speaking of a deficiency, says it "is the amount which he (the taxpayer) admits to be due, and not the amount which appears upon the face of his return, which is deemed the starting point in the computation of a deficiency." If this be a correct statement of the law, it would appear manifest that the commissioner determined a deficiency in the case at bar for the year 1922 by reason of the fact that in his return

the petitioner admitted a tax liability in an amount less than that as finally determined by the commissioner, and hence the Board of Tax Appeals was vested with jurisdiction to hear and determine the petitioner's appeal for the calendar year 1922, and erred in refusing to entertain the petitioner's appeal with reference thereto.

## CONCLUSION.

For all of the foregoing reasons, we submit that the original tax returns filed by the petitioner for the years in question were neither computed in accordance with the method of accounting regularly employed nor did they correctly reflect his true income for the period in question; that the Board of Tax Appeals had jurisdiction to hear and determine the petitioner's appeal for the year 1922, and that the board erred in its determination of these questions.

Respectfully submitted,

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